

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:MAN:TL-N-2246-99

JPappas/GMackey

date:

to: District Director, Manhattan District
Attn: Charles Shepard, Case Manager, Group 1154

from: District Counsel, Manhattan

subject:

Uniform Issue List Number: 6402.01-02

We have been asked for assistance in determining whether the above-named taxpayer is entitled to refunds of interest for tax years in which the taxpayer elected to apply overpayments to the subsequent years' tax liabilities and the Service later determined deficiencies for the overpayment years.

DISCLOSURE STATEMENT

This document may include confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the Internal Revenue Service, including the taxpayer involved, and its use within the Internal Revenue Service should be limited to those with a need to review the document in relation to the subject matter of the case discussed herein. This document is also tax information of the instant taxpayer which is subject to I.R.C. § 6103.

ISSUE

When does interest begin to accrue when a taxpayer elects to apply an overpayment to a subsequent year's estimated tax payments and the Service later determines that there is a deficiency in the overpayment year?

CONCLUSION

Interest accrues on the portion of any subsequently determined deficiency to the extent that it is less than or equal to the overpayment as of the date or dates the overpayment is applied to the succeeding year's estimated tax liabilities. To the extent that the overpayment is not needed to satisfy specific installments of estimated tax of the subsequent year, interest begins to accrue on the subsequently determined deficiency as of

the original due date of the subsequent year's income tax return.

The taxpayer's claim for refund of interest paid on deficiencies for [REDACTED] and [REDACTED] should be allowed to the extent that the claim comports with this conclusion.

FACTS

The taxpayer, [REDACTED], is a corporation that uses the calendar year. The taxpayer filed for an extension, until September 15, [REDACTED], to file its [REDACTED] Form 1120, U.S. Corporation Income Tax Return. The return was filed on [REDACTED], and reported an overpayment of \$ [REDACTED], which the taxpayer elected to have applied to its [REDACTED] estimated taxes. The taxpayer did not designate to which quarter the credit was to be applied. The taxpayer made quarterly payments on its [REDACTED] tax liability to the extent that none of the [REDACTED] credit elect was needed to satisfy the [REDACTED] estimated payments.

The taxpayer filed for an extension, until September 15, [REDACTED], to file its [REDACTED] Form 1120. The return was filed on [REDACTED], and reported an overpayment of \$ [REDACTED], which the taxpayer elected to have applied to its [REDACTED] estimated taxes. Again, the taxpayer did not designate to which quarter the credit was to be applied. The taxpayer made quarterly payments on its [REDACTED] tax liability to the extent that none of the [REDACTED] credit elect was needed to satisfy the [REDACTED] estimated payments.

On [REDACTED], the Service determined deficiencies for both [REDACTED] and [REDACTED] in the amounts of \$ [REDACTED] and \$ [REDACTED], respectively. The taxpayer made advance payments in full on the deficiencies for both [REDACTED] and [REDACTED] on [REDACTED]. At that time the taxpayer also paid interest on the deficiencies for both years, which the Service calculated as though the overpayments had been applied on April 15, [REDACTED], and April 15, [REDACTED], the due dates for the first estimated tax payments for [REDACTED] and [REDACTED], respectively.

In a letter dated [REDACTED], the taxpayer made an informal claim for refund of a portion of the interest on the deficiencies pursuant to the decisions in May Department Stores v. United States, 36 Fed. Cl. 680 (1996), acq. AOD CC: 1997-008 (Aug. 4, 1997) and Sequa Corp. v. United States, 99-1 USTC ¶ 50,379 (CCH) (S.D.N.Y. 1998), discussed below. On [REDACTED], the taxpayer filed an amended informal claim seeking a greater amount of refund based on the same grounds. Finally on [REDACTED], the taxpayer filed Form 843, Claim for Refund and Request for Abatement, to which the taxpayer attached the letters of [REDACTED] and [REDACTED].

To date, the Service has not acted on the claims.

LAW AND ANALYSIS

I.R.C. § 6601(a) provides that "[i]f any amount of tax . . . is not paid on or before the last date prescribed for payment, interest on such amount . . . shall be paid for the period from such last date to the date paid." The date prescribed for payment of income tax is the

due date for the tax return, without regard to extensions. I.R.C. §§ 6151 and 6601(b). In general, the government is entitled to interest on a deficiency in tax for the period that a tax is both due and unpaid. Avon Products v. United States, 588 F.2d 342 (2d Cir. 1978).

Revenue Ruling 88-98, 1988-2 C.B. 356, addresses situations in which the Service determines a deficiency in tax after a taxpayer has elected to have an overpayment that is claimed on a timely filed return (including one filed under extension) for the deficiency year credited against an installment of the succeeding year's estimated tax liability. The Revenue Ruling concludes that interest on the subsequently determined deficiency runs from the due date of the installment payment against which the overpayment was credited on the part of the deficiency that is equal to or less than the claimed overpayment, and from the original due date of the first year's return on the remainder of the deficiency.

Revenue Ruling 88-98 conforms to Avon Products, in which the court interpreted I.R.C. § 6601(a) to mean that interest on a deficiency can only be charged when the tax is both due and unpaid. An income tax liability is due as of the original return filing due date and under the Avon Products analysis, a deficiency is paid as of that due date to the extent that there are sufficient payments in the account to cover the liability. The tax liability does not become unpaid until the date on which amounts that were in the account on the due date have been refunded to the taxpayer or credited to another tax liability.

The revenue ruling also states that the critical date as of which a tax becomes unpaid is the due date for the estimated tax installment payment that the taxpayer designates for payment using the overpayment credit. If the taxpayer does not designate a specific installment payment, the Service uses the earliest installment due date for the succeeding year.

In May Department Stores v. United States, 36 Fed. Cl. 680 (1996), acq. AOD CC: 1997-008 (Aug. 4, 1997), the taxpayer elected to credit an overpayment from its 1983 tax year to its 1984 estimated tax liability but did not indicate a specific installment. When a tax deficiency was later determined for the 1983 tax year, the Service relied upon Revenue Ruling 88-98 to compute interest on the underpayment from the due date of the first 1984 estimated tax installment. Before the credit elect was made on October 15, 1984, with the filing of the 1983 return, however, the taxpayer had already made sufficient estimated tax payments for the first two quarters of 1984 to avoid any addition to tax that might have been imposed under I.R.C. § 6655 for failure to pay estimated tax.

The Court of Federal Claims concluded that the overpayment was not needed to satisfy any installment prior to the date when the return was filed. The Service, therefore, could not assess interest for the period between the due date of the first installment to the date the return was filed because it had the use of the taxpayer's money during that time.

In light of the decision in May Department Stores, the Service reconsidered how it determines interest on a subsequently determined deficiency under I.R.C. § 6601(a) when the taxpayer makes an election to apply an overpayment to the succeeding year's estimated

taxes. When such an election is made, the overpayment will be applied to unpaid installments of estimated tax due on or after the date the overpayment arose, in the order in which they are required to be paid to avoid an addition to tax for failure to pay estimated income tax under I.R.C. §§ 6654 and 6655. The Service will assess interest on a subsequently determined deficiency for the overpayment year from the date (or dates) that the overpayment is applied to the succeeding year's estimated tax obligations.

In all situations, the estimated tax rules in effect for the tax year to which the overpayment is credited will be used to determine the amount of estimated tax due and thus the amount of the overpayment needed to satisfy the obligation for each installment of estimated tax. Any remaining balance of the overpayment credit will be applied as of the due date, without extensions, for filing the succeeding year's income tax return.

The Service's position does not contravene the holding in Sequa Corp. v. United States, 99-1 USTC ¶ 50,379 (CCH) (S.D.N.Y. 1998), in which the district court determined that a corporation was entitled to a refund of interest assessed for the period between its election to credit an overpayment of tax to the succeeding year and the date that overpayment was applied to satisfy a subsequently determined deficiency for the overpayment year. The court held that the date an overpayment becomes a payment on account of the succeeding year's estimated tax determines the date the prior year's tax became unpaid for purposes of I.R.C. § 6601(a). Prior to that date the government has use of the funds with respect to the prior year's tax, and no interest is payable on the overpayment that is the subject of the taxpayer's election. See I.R.C. § 6402(b); Treas. Reg. §§ 301.6402-3(a)(5) and 301.6611-1(h)(2)(vii).

Accordingly, when a taxpayer reports an overpayment in one year and elects to have the overpayment credited to its estimated taxes for the succeeding year, the Service takes the position that interest accrues on the portion of any subsequently determined deficiency to the extent that it is less than or equal to the overpayment as of the date or dates the overpayment is applied to the succeeding year's estimated tax liabilities. To the extent that the overpayment is not needed to satisfy specific installments of estimated tax of the subsequent year, interest begins to accrue on the subsequently determined deficiency as of the original due date of the subsequent year's income tax return. In that case, the overpayment is credited to the subsequent year as of the due date of the return.

The taxpayer's overpayment credits from [REDACTED] and [REDACTED] were not needed to satisfy the taxpayers [REDACTED] and [REDACTED] estimated tax payments. The credits, therefore, were applied to the subsequent years' accounts as of the due dates of the subsequent years' returns, March 15, [REDACTED], and March 15, [REDACTED], respectively.

The subsequently determined deficiency for [REDACTED] was \$ [REDACTED]. The [REDACTED] credit elect was \$ [REDACTED], and was not used until March 15, [REDACTED], when it was applied to [REDACTED]. Interest on the portion of the deficiency that is less than or equal to the credit elect, \$ [REDACTED], began to run when it was used, on March 15, [REDACTED], the date it was applied to [REDACTED]. Interest on \$ [REDACTED] of the [REDACTED] deficiency, therefore, began to run on March 15,

_____. Interest on \$_____ (\$_____ - \$_____) of the deficiency began to run on March 15, _____, the due date of the _____ return.

Similarly, the subsequently determined deficiency for _____ was \$_____. The _____ credit elect was \$_____, and was not used until March 15, _____, when it was applied to _____. Interest on the portion of the deficiency that is less than or equal to the credit elect began to run when it was used, on March 15, _____, the date it was applied to _____. The entire _____ deficiency is less than the _____ credit elect. Interest on the entire _____ deficiency, \$_____, therefore, began to run on March 15, _____.

In conclusion, the taxpayer's claim for refund should be allowed to the extent that it claims an overpayment of interest that comports with this analysis. We remind you that this is proposed advice, which is subject to National Office post review. We will contact you within two weeks of this memorandum to discuss the National Office comments, if any, about this proposed advice.

If you have any questions, please call Jeannette D. Pappas or Gerard Mackey, the attorneys assigned to this case, at 212-264-1595.

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